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Stone Energy Corporation SGY

Analyst Report

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Top Rated Stocks in Sector



by Catharina Milostan

Analyst Note 07-20-2009

News from Murphy Oil [MUR](#) of its deepwater oil discovery at Turquoise Marine-1 offshore Republic of Congo marks another offshore discovery this summer. The recent slew of offshore oil and gas discoveries is the net result of many producers' decisions to keep some offshore drilling alive, even while cutting back on U.S. onshore drilling activity this year. The longer-term nature of offshore projects plus more success because of a growing understanding of underlying deposits are just two of the factors driving offshore producers to forge ahead with drilling plans this year.

Although many major oil firms garner attention for deepwater discoveries, some smaller firms are getting noticed because of deepwater discoveries announced within the last two months. Any one discovery may not change the firm's production outlook, but these discoveries could add up to drive longer-term production growth. A spate of discoveries in the U.S. Gulf of Mexico this summer illustrates greater knowledge of potential deposits. Murphy's Turquoise Marine-1 discovery follows the June announcement of the Samurai oil discovery located in the U.S. Gulf of Mexico. Production from the Murphy-operated Thunder Hawk field in the Gulf of Mexico began in early July. Newfield Exploration [NFX](#) and Stone Energy [SGY](#) announced its Pyrenees discovery in June in the Garden Banks area offshore Louisiana. This was more welcome news for Stone Energy given our long-standing concerns over whether the firm can find enough new wells to offset offshore production declines. Stone Energy's \$53 million common stock offering in June may provide some liquidity support, but we're still concerned about the firm's long-term production growth potential. For Newfield, the Pyrenees discovery adds to the firm's existing deepwater portfolio. This includes the winter discovery in the same Garden Blocks region of the Pyrenees find.

Another nonmajor worth noting in the Gulf of Mexico is Noble Energy [NBL](#), which announced discovery at its Isabella well, which will complement projects at Lorien, Ticonderoga, Swordfish and Raton/Redrock to boost its deepwater program. Deepwater production now accounts for 15% of Noble Energy's oil and gas production. Hess [HES](#) has had its share of U.S. deepwater discoveries but is getting noticed for its 40% participation in an offshore Brazil drilling license led by ExxonMobil [XOM](#). Early July news that the Guarani appraisal well in the Santos Basin offshore Brazil was completed with no discovery notice filed led to some speculation. However, we're keeping our expectations in check given the early nature of this prospect and plans by the partners to analyze data to plan for a third well.

Thesis 03-02-2009

Stone Energy faces major challenges in 2009 as it cuts capital spending to maintain liquidity. Management's focus on liquidity is rightly placed, but limited funding options plus

Morningstar Rating

★ ★ ★

Stock Price

As of 07-20-2009
\$8.07

Fair Value Estimate

\$2.00

Fair Value Uncertainty

Extreme

Economic Moat

Narrow

Stewardship Grade

C

Bulls Say

- Stone Energy added much-needed offshore Gulf of Mexico production and drilling prospects by acquiring Bois D'Arc.
- Drilling for deeper oil and gas deposits at existing or acquired offshore fields may lead to production gains.
- Plans to drill exploration wells in the Gulf of Mexico, onshore Gulf Coast, and Appalachia may lead to successful new wells for Stone Energy.

Bears Say

- Stone Energy's plans to integrate acquired Bois D'Arc properties could get derailed by capital spending constraints, delays in posthurricane repairs or unexpected costs.
- Financial market turmoil may limit Stone Energy's ability to secure funding for growth plans, including a reduction in allowed credit facility.
- Lower oil and gas prices, plus still-high offshore oil service costs, could make it challenging for exploitation companies like Stone Energy to redevelop mature oil and gas fields and earn high returns.

offshore operating challenges leaves little room for error.

Stone Energy's primary challenge is whether it can successfully refocus on developing Gulf of Mexico properties. After two hectic years that included two thwarted acquirers in 2006 and year-long strategic review in 2007, managers decided to return to its roots as a shallow-water Gulf of Mexico oil and gas producer. Its long history in the Gulf of Mexico and experience in redeveloping oil and gas fields to squeeze out more production should help. However, the challenges of high depletion rates, high offshore drilling and acquisition costs, and potential hurricane disruptions that led to Stone Energy's original move from the Gulf of Mexico to onshore U.S. have not gone away.

Timing has also not been on Stone Energy's side. To execute its shift back to offshore Gulf of Mexico operations, the firm sold its Rockies properties in mid-2007 and some noncore Gulf of Mexico properties in early 2008. With cash on hand from asset sales, Stone Energy acquired Bois D'Arc for about \$1.65 billion in August 2008. Buying Bois D'Arc added much-needed near-term offshore Gulf of Mexico drilling potential to help bridge the gap before longer-term prospects startup in the Marcellus Shale in Pennsylvania and deeper Gulf of Mexico. However, the Bois D'Arc acquisition closed just before the firm shut-in all of its offshore wells when Hurricanes Ike and Gustav hit the Gulf of Mexico in September 2008. Stone Energy lost six offshore platforms and production was curtailed due to delays in restoring third-party pipeline and processing facilities. Some repairs may linger until this summer. A return to pre-hurricane offshore production plus production from acquired Bois d'Arc properties may help the firm post production gains in 2009. However, we then need to see the firm succeed in finding new oil and gas deposits at acquired and existing properties to drive longer-term growth.

Stone Energy also has several financial challenges. Faced with low oil and gas prices and typically high offshore operating costs, Stone Energy cut its 2009 budget to maintenance levels to keep spending within expected cash generation. The firm amassed a healthy cash balance of \$68 million at year-end 2008 to help provide a cash cushion. But there's little room for error to cover unexpected costs or delays in resuming production. Stone Energy has unused borrowing capacity under its bank credit facility, but that capacity is tied to oil and gas prices and reserve valuation. The firm has already hinted that low oil and gas prices thus far in 2009 may lead to a cutback in borrowing capacity when its bank group re-assesses its credit facility in May 2009.

Stone Energy may have taken major steps to shore up its liquidity for 2009, but challenges remain that could derail its plans. We've long been concerned over Stone Energy's changing sense of strategic direction and it wasn't long ago that a major reserve write-down in 2005 led to class-action lawsuits and a regulatory inquiry. Low near-term oil and gas prices combined with typically higher-cost offshore drilling and limited funding options for Stone Energy adds up to greater uncertainty for earnings and cash flow. These factors, combined with Stone Energy's company-specific challenges, warrants our extreme fair value uncertainty rating.

Valuation

We're cutting our fair value estimate to \$2 per share from \$18 per share to reflect growing concern over Stone Energy's ability to manage liquidity this year and drill successfully in later years to drive long-term production growth. We also lowered our oil and gas price assumptions, including a lower long-run perpetual gas price. In our discounted cash-flow model, our benchmark oil and gas prices are based on

Nymex futures contracts for 2009-11. For gas, we use \$5.10 in 2009, \$6.30 in 2010, and \$6.80 in 2011. For oil, we use \$47 in 2009, \$56 in 2010, and \$61 in 2011. We adjust our benchmark pricing to reflect the quality, location, and hedging of the firm's production. In our base scenario, we assume long-run perpetual oil prices of \$80 per barrel and natural gas prices of \$7.50 per mcf. In our base scenario, we took a more conservative view that unexpected capital spending or delays in post-hurricane repairs could stress the firm's expected cash flow this year. To help manage cash flow, Stone Energy has favorably priced oil and gas hedges in 2009 and 2010. However, a potential cut in Stone Energy's allowed borrowing base after a bank re-assessment in May 2009 could limit the firm's ability to cover unexpected costs. Longer-term, we need to see Stone Energy find enough new production from deeper or overlooked oil and gas deposits to offset the typically high production decline rates for Gulf of Mexico wells. The firm needs to add value at acquired Bois D'Arc properties by drilling successfully at new well sites. In our low case where perpetual prices drop to \$50 per barrel for oil and \$5 per mcf for gas, we look for a further pullback in production and cash flow, resulting in a fair value estimate of \$0.75 per share. Our high case assumes long-run oil prices of \$150 and gas prices of \$15 and higher capital spending for drilling. A higher price environment may support more exploration drilling in the Gulf of Mexico, onshore Gulf Coast, and Appalachia. In our high case, our fair value estimate would climb to \$6 per share.

Risk

Stone Energy's primary risk is a sustained drop in oil and gas prices that could reduce cash flow. It also has a risk in securing new funding due to high debt levels in a troubled financial market. As a mostly offshore producer, Stone Energy has added risks of high operating and exploration costs plus storm-caused production disruptions without offsetting production from other regions.

Close Competitors	TTM Sales \$Mil	Market Cap \$Mil
Stone Energy Corporation	730	322
* Mariner Energy, Inc.	1,228	1,078
* EPL	432	5
* McMoRan Exploration Co.	874	412
* ATP Oil & Gas Corporation	473	259

* Morningstar Analyst Report Available

Data as of 03-31-09

Strategy

Stone Energy returned to a strategy of drilling exploitation-type wells in the Gulf of Mexico to drive growth. The mid-2008 acquisition of Bois d'Arc added near-term offshore drilling potential to help bridge the gap before longer-term prospects startup in the Marcellus Shale in Pennsylvania and deeper Gulf of Mexico. Drilling success will be crucial toward achieving the firm's strategy.

Management & Stewardship

CEO and president David Welch came to Stone Energy in April 2004 from BP BP. He embarked on a program to diversify out of the Gulf Coast and increase operating efficiencies. Welch managed through some tough years from the troubling reserve restatement in 2005, through two failed attempts to be acquired in 2006 and review of strategic alternatives in 2007, and remains at the firm's helm. Founder James Stone stayed on as chairman of Stone Energy until his passing in January 2008. The firm elected R.A. Pattarozzi as its nonexecutive chairman of the board in early February 2008. The rest of the management team

includes a mix of longtime Stone managers on the operational side and recent hires on the financial and administrative side. Welch's total compensation in 2007, including salary, bonus, and stock options, was similar to industry peers at \$3 million; a commendable 85% of this was discretionary and performance-based. We like how management has a stake in Stone Energy and how all employees have a stock component to their compensation.

Profile

Louisiana-based Stone Energy is primarily an offshore Gulf of Mexico and Gulf Coast oil and gas producer. After selling its Rockies properties, Stone Energy boosted offshore Gulf of Mexico operations by acquiring Bois D'Arc Energy in August 2008. The firm also has some Appalachian properties. In 2008, daily production averaged 175 million cubic feet of gas equivalent and year-end 2008 proved reserves were 519 billion cubic feet of gas equivalent.

Growth

Stone Energy's growth may be limited over the next few years as low oil and gas prices and limited funding sources force a cutback on spending. Longer-term growth will hinge on whether the firm finds enough new deposits at existing and acquired Bois d'Arc properties to offset typically high production decline rates in the Gulf of Mexico.

Profitability

Operating margins fluctuated between a positive 35% to 38% in three of the last five years and negative operating margins in 2006 and in 2008 due to reserve write-downs. Low oil and gas prices, high offshore operating costs, and hurricane-repair costs could pressure profit margins over the next few years.

Financial Health

Stone Energy's financial flexibility is now limited amid financial market turmoil. Debt levels have fluctuated due to asset sales and acquisitions. After the sale of Rockies assets, the firm's net debt/capitalization level improved to a negative 6% at year-end 2007. However, this ratio grew to a too-high 54% at year-end 2008 due to new debt incurred to acquire Bois D'Arc and year-end asset impairment charges. This high debt level and financial market crisis may limit the firm's ability to secure new financing.

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